

Private foundations; minimum investment return; computation; portion of building used commercially. A private foundation owns a building, a portion of which is used directly in carrying out its exempt purposes, with the remainder leased to commercial tenants. The percentage of exempt use of the building, for purposes of determining the foundation's minimum investment return under section 4942(e) of the Code, should be determined by dividing the fair rental value of that portion of the building used for exempt purposes by the fair rental value of the entire building.

ISSUE

Should the percentage of 'exempt use' of a building owned by a private foundation, for purposes of section 4942(e) of the Internal Revenue Code, be determined by dividing that portion of the square footage of the building used for exempt purposes by the total area of the building, or by dividing the fair rental value of that portion of the building used for exempt purposes by the fair rental value of the entire building?

FACTS

The foundation, which is exempt from federal income tax under section 501(c)(3) of the Code and a private foundation under section 509(a), owns a building. The building is used directly in carrying out the foundation's exempt purpose, except for less than five percent of its square footage, which is leased to commercial tenants. That fair rental value of that portion of the building leased to commercial tenants is more than five percent of the total fair rental value of the building.

LAW AND ANALYSIS

Section 4942 of the Code provides for an excise tax on certain undistributed income of a private foundation. The amount of income required to be distributed by a private foundation with respect to a particular taxable year is its distributable amount.

Section 4942(d) defines the term 'distributable amount' to mean an amount equal to the minimum investment return reduced by the sum of the taxes imposed on such private foundation for the taxable year under subtitle A and section 4940.

Section 4942(e)(1)(A) of the Code excludes from the computation of the minimum investment return assets that are used (or held for use) directly in carrying out the foundation's exempt purpose.

Section 53.4942(a)-2(c)(3)(i) of the Foundation Excise Tax Regulations provides that an asset is used (or held for use) directly in carrying out a foundation's exempt purpose only if the asset is actually used by the foundation in carrying out its

exempt purpose. The regulations further provide that where property is used both for charitable, educational, or other similar exempt purposes and for other purposes, if such exempt use represents 95 percent or more of the total use, such property is considered to be used exclusively for a charitable, educational, or other similar exempt purpose. If the exempt use of such property represents less than 95 percent of the total use, reasonable allocation between such exempt and nonexempt use must be made.

In determining whether 95 percent or more of the asset described above is used in carrying out the foundation's exempt purpose, the fair rental value of the portion of the asset used for nonexempt purposes must be determined and compared to the fair rental value of the entire asset. See section 53.4942(a)-2(c)(3)(i) of the regulations. If, based on this fair rental value comparison, nonexempt use of the asset is more than five percent of the total use of the asset, an allocation of the asset's fair market value must be made between exempt and nonexempt use, and only the amount allocated to the exempt use may be excluded from the computation of the foundation's minimum investment return. On the other hand, determining 'exempt use' by dividing that portion of the square footage of the building used for exempt purposes by the total area of the building may not provide adequate representation of the value of that part of an asset used for exempt and nonexempt purposes.

HOLDING

The percentage of 'exempt use' of the building owned by the private foundation, for purposes of section 4942(e) of the Code, should be determined by dividing the fair rental value of that portion of the building used for exempt purposes by the fair rental value of the entire building. Since in this case the fair rental value of that portion of the building leased to commercial tenants is more than five percent of the total fair rental value of the building, the fair market value of the building must be allocated between exempt and nonexempt use in computing the foundation's minimum investment return under section 4942(e) of the Code.